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Directive 99-5: 2-Percent S Corporation Shareholders Treatment of Fringe Benefits Health Insurance Premiums

Issue

Chapter 319 of the Acts of 1998 incorporated into Massachusetts personal income tax law the Internal Revenue Code (Code) as amended and in effect on January 1, 1998. As a result, in computing Massachusetts adjusted gross income, is a 2-percent shareholder of an S corporation now entitled to the Code § 162(l) deduction available to an individual who is an employee within the meaning of § 401(c)(1) of the Code for health insurance premiums paid by the S corporation on behalf of the shareholder and his or her spouse and dependents?

Directive

Yes. For Massachusetts personal income tax purposes, a 2- percent shareholder of an S corporation is now entitled to the deduction under § 162(l) of the Code available to § 401(c)(1) employees for health insurance premiums paid by the S corporation on behalf of the shareholder and his or her spouse and dependents.

Discussion

Under § 1372 of the Code, S corporations are treated as partnerships with respect to fringe benefits and their 2-percent shareholders are treated as partners with respect to such benefits. I.R.C. § 1372(a). The value of fringe benefits provided to a partner as a partner is generally treated as a guaranteed payment includible in the gross income of the partner and deductible by the partnership as an ordinary and necessary business expense. Rev. Rul. 91-26; 1991-1 C.B. 184. Similarly, the value of fringe benefits provided to a 2-percent S corporation shareholder is includible in the gross income of the shareholder and deductible by the S corporation as an ordinary and necessary business expense. Id.

Partners are employees within the meaning of § 401(c)(1) of the Code. Therefore, for the tax treatment of fringe benefits available to 2-percent shareholders of an S corporation, the rules applicable to § 401(c)(1) employees also apply. Under § 162(l) of the Code, § 401(c)(1) employees are allowed a deduction for medical insurance premiums paid by their employer on their behalf and that of their spouse and dependents. For the 1998 tax year, the federal deduction is equal to 45% of the premiums. Because 2-percent shareholders of an S corporation are treated as partners for purposes of fringe benefits, they are entitled to this deduction for federal tax purposes. IRC §§ 1372 and 162(l); Rev. Rul. 91-26.

Under G. L. c. 62, § 2(d)(1), there is a deduction for "deductions allowable under [Code] §§ 62 and 404 without regard to § 265" Id. Section 62 (a)(1) of the Code allows a deduction for trade or business expenses which, in turn, are set out in § 162 of the Code.

With the enactment of chapter 319 of the Acts of 1998, Massachusetts now incorporates into the Massachusetts personal income tax law the Code as amended and in effect on January 1, 1998. See TIR 98-15. Therefore, Massachusetts now allows the Code § 162(l) deduction for medical insurance premiums for Massachusetts tax purposes.

For the deductibility of S corporation qualified retirement plan contributions by shareholder-employees, see DOR Directive 99-4.

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